

HOLES IN THE CORPORATE VEIL: CONFRONTING THE MYTH OF REDUCED
LIABILITY FOR SMALL BUSINESSES AND ENTREPRENEURS UNDER CORPORATE
FORMS

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ABSTRACT

Entrepreneurship textbooks are devoid of some of the more complex legal analysis that would lead would-be business founders to a more informed understanding of the limitations of corporate forms in affording protection from personal liability. Indeed, these texts may have contributed to what amounts to a myth in causing entrepreneurs to believe that they are personally separate and invulnerable, so long as they have taken the step to incorporate, as compared to operating as an individual under a sole proprietorship. The authors of this paper have quoted the term “myth,” because practicing corporate attorneys and the plaintiffs they represent, the courts, and legal scholars are keenly aware of ongoing efforts to devise strategies and methods to pierce the corporate veil; of course, defendants also do become aware of their vulnerabilities (but perhaps too late).

Despite such a legal landscape, our review of contemporary entrepreneurship textbooks and the scholarly literature of entrepreneurship undergirding these texts demonstrated a failure to convey that increasingly, there are holes in the corporate veil. This paper provides an overview of issues that merit consideration on the topic of the corporate veil and veil piercing, and concludes with a discussion of implications for entrepreneurship teaching, research, and practice.

INTRODUCTION

“An important consideration in starting a business is whether to form it as a corporation. Organizing a business as a corporation offers many advantages. For example, the ability to sell stock can be a significant help when raising capital” (Peckinpaugh, 2000). “When presented with any kind of potentially devastating liability, an attorney’s instinctive response is to create a separate corporation to ‘shield’ the rest of the corporate family, and the individual assets of those who direct it” (Jackson, 2001). The basis for this present paper is dispelling the “myth” (Graham, 2002) of the corporate veil, the affects of which are the mistaken opinion that entity formation makes individuals bullet proof for all but acts of fraud (Lowenstein, 1989; Prieston, 1999; Russell, 2004; Shub, 2006; Wagoner, 1996) and intentional acts of gross negligence (Bendremer, 2005; Hughes, 2004; Rolle, 2003).

The authors of this paper believe that this myth is due to a paucity of coverage in entrepreneurship textbooks, and because a lack of attention has been given to veil piercing in the scholarly literature of entrepreneurship, which at least insofar as this topic is concerned seems to exist in a relative vacuum, separate from legal scholarship. This statement should not be interpreted as a criticism. Rather, we recognize that entrepreneurship is a relatively new and emergent scholarly discipline. Further, we think it is quite reasonable to posit that perhaps other factors are in play, such as the widely disseminated explanations regarding the benefits of forming a corporation that appear in generalized business books, on web sites, and in articles disseminated through the popular press and trade publications (sans any adequate explanation to the effect that “there is always a catch” – one must abide by certain rules and conditions in order to pass the legal test of veil piercing).

“Most savvy business people are aware that corporations offer some protection to officers, directors and shareholders from personal liability. What many people may not know is that the corporate shield from personal liability is not infallible” (Hughes, 2004). As suggested by practicing attorney Stanford A. Graham, Esquire, “the majority of veil piercing activity never makes it to the courtroom. Rather, when business owners are threatened with litigation, and become aware of their vulnerability to veil piercing, they pay expensive settlements to avoid litigation” (Graham, 2002). Indeed, “situations are often compromised because they are so expensive to litigate” (Hays, 1998). Settlements under a threat of suits that may involve veil piercing are also possible, and in these instances, reporting may be obscured (Guglielmo, 1996).

Generally, piercing is a remedy to hold individuals accountable for abuses of the corporate form, including hiding behind a corporate entity in order to defraud creditors, investors or other claimants (Bainbridge, 2001; Caudill, 2003; Mirchandani, 1998; Russell, 2004; Wagoner, 1996).

“The [veil piercing] doctrine most often arises in connection with plaintiffs’ attempts to hold corporate shareholders liable for the debts of the corporation” (Bendremer, 2005). As case law indicates, being undercapitalized (and knowing so) is not reason to hide behind the corporate veil when one defaults on a contract or other obligation (Peckinpough, 2000). In instances such as these, the remedy (on the part of a plaintiff) of veil piercing is apparent because the business was undercapitalized to carry out the terms of the agreement from the start.

However, veil piercing can become even more tumultuous, and “the risk is much greater than most people realize” (Graham, 2002). The corporate veil will not protect a business when acts or omissions will result in unfairness to the injured party: “The determination of whether the doctrine applies centers on whether there is an element of injustice..., fundamental unfairness, or inequity” (“State ex rel. Christensen v. Nugget Coal Co.,” (1944). Unfairness!!! To this we exclaim “holy cow,” as the inclusion of this descriptive term in the court’s finding is very far reaching, as most *any* plaintiff can assert unfairness.

For the reasons suggested above, we were compelled to offer this first paper as a contribution to the scholarly literature of small business and entrepreneurship (hereinafter our references to the scholarly literature of small business and entrepreneurship will be expressed simply as, “entrepreneurship” for purposes of brevity and expediency).

REVIEW OF EXISTING LITERATURE ON “PIERCING THE CORPORATE VEIL” WITHIN THE SCHOLARLY LITERATURE OF ENTREPRENEURSHIP

Vanderbilt University Professor of Law Robert Thompson (Robert B. Thompson, 1995) is regarded to have provided an “exceptional study” of veil piercing (Morrissey, 2007; Rapp, 2006). “Veil piercing issues can also arise with regard to limited partnerships (‘LPs’) and limited liability partnerships (‘LLPs’). Like LLCs, LPs and LLPs are unincorporated business entities” (Bendremer, 2005). However, the need for this present paper became evident after a series of searches in the scholarly entrepreneurship literature revealed a dearth of research on the subject of the corporate veil and veil piercing. Search attempts conducted on databases used by *ProQuest* demonstrated that veil piercing was only covered within the literature from within scholarly and professional legal and accountancy contexts, typically associated with legal, finance or accounting oriented journals.

With parameters for our searches set to identify only articles with full-text availability and results in the citation and abstract, we identified 155 articles in *ProQuest* databases

originating from sources that were not associated with the scholarly entrepreneurship literature. Upon attempting to combine the term “corporate veil” with others such as “corporate veil” AND “entrepreneurship” we found only one result (from an Australian journal published in 1992).

The popular business press produced some results in our *ProQuest* searches (but upon examination, some of these were erroneous and associated with other topics). Finally, we also examined several leading entrepreneurship textbooks and found that forms themselves were typically well covered, but emphasis on possible pitfalls and vulnerabilities was not as well developed as probably should be (Hisrich, Peters, & Shepherd, 2008; Kuratko & Hodgetts, 2007; Price, 2005; Roberts, Stevenson, Sahlman, Marshall, & Hamermesh, 1998; Wickham, 2006; Zimmerer, Scarborough, & Wilson, 2008). We presume that the paucity of results in the entrepreneurship scholarly literature may partially or largely explain the scant coverage of issues and consequences associated with veil piercing in contemporary entrepreneurship texts. Many misconceptions (Mauldin & Wilder, 1997) appear to exist.

Besides the general lack of coverage in entrepreneurship texts and the scholarly entrepreneurship literature which undergirds those texts, veil piercing is an evolutionary (Bendremer, 2005) topic within the legal community. It has also “been one of the most hotly debated concepts in business law” (Rapp, 2006), with “a long, if controversial, history in the law of business” (Morrissey, 2007). However, both the would-be and established entrepreneur may typically fall under the false impression that the corporate form provides a bullet-proof shield (Graham, 2002) of protection against personal liability claims. “Statutes created the legal fiction of the corporation being a completely separate entity which could act independently from individual persons” (Eisenberg, 2005). Beyond liability issues, other circumstances such as tax consequences dictate that one should “frequently consider and reconsider the entity options” that may be available (Massingill & Mares, 2007).

AN ABBREVIATED HISTORY OF THE CORPORATE FORM

The history of corporations is well covered elsewhere (Clemens, 1998; Morrissey, 2007; O’Kelley, 2006; Wells, 2007), and it is not our purpose to retell that history in this present paper. However, a brief review should serve to provide context for entrepreneurship scholars who have not arrived here through education or practice with specializations in management or corporate law. As outlined by Morrissey (Morrissey, 2007):

The earliest corporations in British legal history were ecclesiastical and other privileged organizations chartered by the sovereign and allowed perpetual existence beyond the life-time of their individual members.³⁰ In the new American Republic, incorporation continued to require individual acts by legislatures,³¹ which were most often granted for special projects such as creating canals, banks,³² or roads. As the industrial revolution began in earnest in the U.S. around 1825, businesses began to need capital from widespread investors. At that time, corporate statutes first started providing limited liability for shareholders³³ and state legislatures created general laws allowing businesses to incorporate by merely filing certain documents with designated government officials.³⁴ Parliament passed the first Limited Liability Act in 1855³⁵ and by then limited liability had also become a standard feature in the corporate codes of American States.³⁶

In the United States, the State of Wyoming passed the first LLC statute (in 1977), “but it was not until 1988 that LLCs received considerable attention following an IRS ruling clarifying that they could be taxed like partnerships in spite of their limited liability status” (Rapp, 2006). Indeed, “corporate law’s most dramatic revolution of the last quarter-century has been the emergence of the Limited Liability Company (LLC) as the dominant business form for small businesses”

(Rapp, 2006). “Limited liability has always been one of the major attractions of a business form for those engaged in a closely held business” (Robert B. Thompson, 1997).

In terms of the present state of affairs in the corporate and legal arena (and again, with no apparent acknowledgement in entrepreneurship textbooks or scholarly literature), “veil piercing is the most litigated area of American corporate law” (Rapp, 2006).

METHODS BY WHICH VEIL PIERCING MAY OCCUR

“Veil rules share a family resemblance with rules that forbid conflicts of interest [i.e., “self-interested decision making,” also used here as an explanatory comment from elsewhere within Vermeule]” (Vermeule, 2001). “The doctrine of veil piercing has its origins in corporate jurisprudence and usually arises in the corporate context” (Bendremer, 2005). “The doctrine holds that in order to encourage investment, and to protect investors from losing more than their initial investment, no liability should be imposed upon shareholders beyond the corporate assets” (Rolle, 2003). However, as is the case for many rules, exceptions typically follow.

The applied test for corporate veil-piercing is *Van Dorn Co. v. Future Chemical and Oil Corp.*, 753 F.2d 565 (7th Cir.1985). (“*Van Dorn Co. v. Future Chemical and Oil Co.*,” 1985). A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met: “(F)irst, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual (or other corporation) no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.” “Corporate veil piercing most often applies in cases of (i) fraud; (ii) inadequate capitalization; (iii) failure to adhere to corporate formalities; and (iv) abuse of the corporate entity that results in complete dominance by the shareholder or shareholders” (Bendremer, 2005).

“Normally when the [veil piercing] doctrine is used, it is used to punish corporate directors for financial misconduct, but in the wake of Enron and similar scandals, ‘there’s a general siege on the walls of corporate immunity’” (Anonymous, 2006). Although certainly not the first (and we presume not the last) corporate scandal to occur, the Enron case has been exposed as a tragedy affecting employees, shareholders and others, such as the Arthur Andersen accounting firm partners who became embroiled in the controversy surrounding its demise (Pacelle & Dugan, 2002). In the latter instance, this occurred when “Enron creditors, shareholders and employees...[sought] to recover the billions of dollars they have lost from someone” (Pacelle & Dugan, 2002).

Among its other transgressions, “energy giant Enron Corp...gave gifts to non-profits associated with Enron board members” (Klein, 2005). The issues were indeed systemic, as a culture of corruption arose (Emshwiller & Smith, 2001). As suggested in a *Knight Ridder Tribune Business News* editorial, (“Editorial: The corporate veil,” 2006):

American business leaders cannot have it both ways. They cannot allege on the one hand that a corporation is like an individual with all the rights of free speech and privacy accorded to individuals and on the other hand attempt to conceal wrong-doing by disclaiming knowledge, like the piano player in a house of ill-repute who denies knowing anything about what’s going on upstairs. In the Enron trial, which began this week, Enron big-wigs Kenneth Lay, company founder, and former CEO Jeffrey Skilling are expected to defend themselves against felony charges with the classical “barefoot boy on Wall Street” defense that “how wuz they supposed to know” about all the cooking of corporate books and other skullduggery that eventually brought the company to ruin.

“Exposure of Enron’s frauds triggered a national debate on the need for corporate reform” (Jones, 2004).

Of course, Enron was not the only scandal to shake investors’ confidence in capital markets. As allegations of fraud were brought forward against other giants such as Worldcom, “Wall Street was harboring a dirty little secret. Some of its highest paid investment bankers were handing out hot IPO³ shares in return for kickbacks. Others were offering favorable stock recommendations from their research analysts [who suffered from numerous conflicts of interest]” (Scianni, 2003). Collectively, these scandals led to the Sarbanes-Oxley Act, which was signed into law by President Bush in July 2002 (Scianni, 2003).

Notwithstanding the above high profile instances of fraud and scandalous behavior, smaller firms are more likely to make mistakes or otherwise commit acts that lead to the use of the veil piercing remedy on the part of plaintiffs (a discussion regarding prevention is provided in a subsequent section of this paper). In some instances, incorporations may occur in an effort to avoid preexisting personal liability issues. For example, in a Norfolk Virginia case, the court determined that two roofing contractors engaged in an effort to evade personal liability by hiding behind a corporate shield (rather than simply addressing problems by replacing or repairing defects in the roof they constructed for a condominium complex): “the evidence supports the conclusion that they simply determined to form...[a corporation] and, ultimately, to use that corporation to evade personal liability while the condominium continued to be marketed with a known defective roof” (S. Williams, 2003).

As was determined through a case decided by the Saint Louis County trial court, the defendant, an orthopedic surgeon, “went to great lengths to divert his earnings from his debtor into various corporations” (Umbright, 2004). Among other things (e.g., shifting monies to various trusts and corporations), he “had not received any wages for his medical services...because those wages were transferred to his wife” (Umbright, 2004). Basically, “to pierce the corporate veil of limited liability protecting a company and establish a cause of action against its directors in their personal capacity, there needs to be an assumption of responsibility” (Mirchandani, 1998).

PREVENTING VEIL PIERCING

“Using a corporate form ordinarily will insulate the owners from direct liability for the company's obligations, because the corporation is considered to be a separate legal identity, independent of its owners”(Peckinpaugh, 2000). However, and this is a significant “however” often omitted in form or substantive discussions within textbooks, the scholarly literature of entrepreneurship, and in popular press outlets: this shield can only be effective if certain conditions are met. These conditions vary somewhat from state to state, and courts have interpreted cases based on what typically entails extensive examination of whether or not veil piercing is a justifiable remedy. In other words, “although using a corporate form for doing business can provide many advantages, investors who use this approach must be careful to follow the rules to maintain those advantages” (Peckinpaugh, 2000).

Certain common principles tend to apply to the concept of veil piercing, regardless of venue (i.e., place where cases are decided). For example, “one of the oldest ways to ‘pierce the corporate veil’ is to show that a corporation was created for an illegal purpose” (Jackson, 2001). Thus, as simplistic as it may sound (upon knowing one of the most common sources of vulnerability), to prevent veil piercing, corporations and individuals within them (or with whom

they have dealings), generally, should be careful not to commit any illegal acts. As another example (fraud), “receiving ‘insider’ and other payments” (Turcotte, 2005) prior to filing for bankruptcy protection would expose a corporation to a veil piercing test. “Tort law in the United States has the same common law foundations as tort law in most other nations” (Rolle, 2003) and fraudulent behavior or negligence associated with illegal acts is certainly suggestive of both litigation as well as what would likely become a successful petition for relief through the veil piercing doctrine.

Hence, one should also “avoid committing any torts. Examples of tort claims are negligence and fraud, in contrast to contracts” (Hughes, 2004). “In a tort case, liability links the defendant to the plaintiff’s injury” (Rolle, 2003). “Tort law provides a structure to understand the separate ‘wrongfulness’ of fraud, but in a way that also could suggest limits on recovery. By recognizing lying as a wrong, law recognizes this conduct as an inappropriate way of treating people that gives rise to an individual right of redress” (R. B. Thompson, Spring 2006). “Tort law encompasses several different categories of civil wrongs, which can empower a judge or jury to impose monetary damages on a tortfeasor if he is found to be liable for the given damages” (Rolle, 2003). For example, “toxic tort law includes a smaller category of civil wrongs, in which there has been some harm ‘to persons, to property, or to the environment’” (Rolle, 2003).

“The right to a law of redress has deep roots in Anglo-American law” (Goldberg, 2005). According to Rolle (2003):

Many corporations are grateful for the protections they are granted and try to set their subsidiaries up so as to avoid liability in the event that any tort allegations arise based on their subsidiaries’ activities. The general rule in the United States is that the parent will not be held responsible for the actions of its subsidiary unless there is some evidence that the parent has perpetrated some fraud.³⁰¹ This kind of fraud is not frequently shown, but where “stock ownership has been resorted to ... for the purpose ... of controlling a subsidiary company so that it may be used as a mere agency or instrument of the owing company or companies,” then the veil may also be pierced.³⁰² When a court finds that this kind of fraud has been committed, it then may “pierce the corporate veil” and reach the assets of the parent.³⁰³ In rare cases, a parent corporation may also be held liable, and lose the protection of the corporate veil, if the plaintiff can show that the parent was directly involved in the day-to-day activities of the subsidiary corporation.³⁰⁴ This is not technically considered piercing the veil, as the parent becomes directly liable for its own actions in these cases, rather than derivatively liable for the actions of its subsidiary.³⁰⁵

“The corporate shield hinges upon the legal fiction that a corporation is a legal entity separate and apart from its owners, officers and directors. To maintain this legal fiction, you must treat the corporation like it is a separate entity” (Hughes, 2004). As a matter of practical implications, small business owners are probably particularly susceptible to mixing personal funds with corporate funds (and both they and their small corporations may easily become intertwined). It is imperative to maintain this separation, because once evidence shows that for all intents and purposes a small business owner is basically identifiable in transactions as one in the same as his or her corporation, or vice versa, the protection of the shield is lost.

Another common way to create problems for a business is to fail to acknowledge the corporate status both in terms of disclosure, but also with respect to other formalities such as entering contracts. As Hughes (2004) suggests:

You should properly identify the corporation at all times. For example, business cards and advertising should include the proper corporate name of your entity, including “Inc.,” “Co.,” “Corp.,” or other appropriate monikers denoting a corporation. Your letterhead and stationary should include the same information. Last, but not least, any contracts entered into by the corporation must have the proper name including corporate designation. Signing

a contract and not including the right name [or your corporation as the party to be bound by the agreement] is a very easy way to become personally liable for all breaches of contract.

Formalities also include “‘corporate governance’ rules [which] cover things such as board of directors meetings, capitalization requirements and reporting requirements” (Peckinpugh, 2000).

In light of an increasingly litigious environment, more organizations have recognized the need to take steps to protect their interests against veil piercing: “The holding company structure operates as an umbrella under which other companies...exist” (Gilpatrick, 2006). Conceptually, holding company configurations and parent-subsidiary arrangements provide another layer of protection. As suggested by Wortham (1998), the notion of formalities is applicable to both small and larger organizations alike:

“Organization of a subsidiary should provide adequate insulation if steps are taken to ensure that the ‘corporate veil’ is not ‘pierced’ by lack of observance of corporate formalities at the subsidiary level. [But] excessively close arrangements (related to management and control) between a parent and its subsidiary increase the likelihood that the subsidiary will be viewed by courts as merely an agent or instrumentality of the parent.”

In other words, “conducting a similar business in a similar location or having interlocking sets of officers, directors, and ownership can create problems” (Hughes, 2004).

We conclude our discussion about veil piercing prevention methods with an interesting quote which articulated the point of view held by authors who are evidently in the trenches representing corporate defendants. In an article entitled, *Humanizing the deep pocket corporation*, T. B. Williams and Dominick (1995) observed:

Corporations are often perceived to be greedy, impersonal and completely indifferent to the effects their activities have on society. To overcome this prejudice...[a corporate defense attorney] must essentially draw the corporate veil, presenting the corporation not as a faceless, single entity, but as a collection of fair, responsible and conscientious individuals.

We find the above approach particularly compelling because it is highly suggestive of a form of transparency that would normally be akin to honesty and innocence on the part of a corporate defendant that had behaved properly in the first place.

CONCLUSION AND IMPLICATIONS FOR ENTREPRENEURSHIP TEACHING, RESEARCH, AND PRACTICE

The authors of this paper have sought to add an important and needed contribution to the scholarly literature of entrepreneurship. Those in favor of piercing the corporate veil are often (at least from their own point of view) justified in their efforts. They also may be formidable in their wherewithal (e.g., banks attempting to collect) and commitment to doing so. Veil piercing efforts are driven not only by the outcome of a single case, but also by the precedents that may be established, which will influence future litigation.

Many contemporary business and entrepreneurship books identify increasing globalization as a significant business trend (and even without textbook knowledge, we would add that it would be difficult for most individuals to remain unaware of this trend). However, particularly as it pertains to veil piercing (which is recognized doctrine in many nation-states), globalization has some additional implications. As observed by McConnaughay (1995):

One of the few predictable consequences of the increasing globalization of corporate conduct is a commensurate increase of litigation in the United States (and presumably elsewhere) involving corporate parties of multiple nationalities. Plaintiffs from abroad increasingly will seek to impose liability on US parents for the acts and obligations of their foreign subsidiaries, while plaintiffs resident in the United States increasingly will seek to impose liability on foreign parents for the acts and obligations of their US subsidiaries. These efforts frequently will involve the invocation of two related (and sometimes interchangeable) doctrines:

** piercing the corporate veil to obtain jurisdiction over a foreign corporate parent (or controlling shareholder); and*

** piercing the corporate veil to impose liability on a corporate parent (or controlling shareholder) for the acts or obligations of its subsidiary.*

Hence, changes in the environment foreshadow the likelihood of an even greater risk that future entrepreneurs (presently students) may encounter an even more complex morass of legal implications associated with their choice(s) of corporate form.

Entrepreneurship educators who may be laypersons in the area of law (as compared to practicing attorneys and legal scholars) may unwittingly contribute to creating a false sense of security about protections afforded under corporate forms in the course of providing instruction. This of course suggests content that is not only presently inadequate, but will be increasingly so in the future.

For the scholarly researcher in small business and entrepreneurship disciplines, as we have found, this paper will represent one of the first contributions of its kind to the literature. This suggests several opportunities for future research. First, is the obvious task of making further connections with the preexisting body of knowledge associated with well established legal scholars and their research. Second, we would suppose that small businesses and entrepreneurial firms may suffer from unique challenges in lacking sufficient access to corporate counsel, being more susceptible to mistakes and subsequent litigation, and more likely to forego formalities that are precisely those that will get them into real trouble. We expect this, but further research and empirical testing would aid in both defining the situation as it now exists (and subsequently addressing matters with practitioners and students who are would-be entrepreneurs).

Finally, as we have indicated, veil piercing is an evolving area and dynamic. Keeping up with changes and then correlating those changes with the concurrently evolving discipline of entrepreneurship is also a recommended course of action for any student, entrepreneurship educator, researcher, or practitioner.

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